In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 354

THOMAS C. BALLAGH AND VERA REED BALLAGH, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

In December 1947, petitioner entered into an annuity contract with the Standard Life Insurance Company under which he was to pay 41 annual premiums of $10,000 each and would then receive, commencing in 1988, an annuity of $6,813 per month for the rest of his life. Petitioner paid the Company $10,000 as the initial premium plus $236,856 as a prepayment of the remaining 40 premiums. The prepayment was credited to a "premium deposit ac-

count" on which interest at the rate of 2.85% was to be credited, the deposit, with interest to be credited, being just sufficient to fund the future premiums. Petitioner then immediately "borrowed" back from the Company the full amount of the premium prepayment, $236,856. The loan bore interest at 4% and was secured solely by the policy and the premium deposit,[1] petitioner having no personal liability for its repayment. The proceeds of the loan were used to repay a one-week bank loan by which the prepayment of the premiums had been financed (Pet. 24-26).

Also in December 1947, petitioner prepaid five years' interest on the loan in the amount of $45,568. In December of 1952, 1953, and 1954, he made interest payments in the amounts of $9,693 (one year's interest), $9,776 (one year), and $19,585 (two years). In December 1956, when the interest for the succeeding year became due, petitioner converted the contract into a paid-up annuity policy. At that time, the net cash value of the contract—the cash surrender value of the policy plus the balance in the premium deposit account less the $236,856

[1] The 4% rate applied only to the portion of the loan secured by the premium deposit account; on the portion secured by the policy itself, the rate was to be 6%. Initially, the premium deposit account provided security for the entire loan, so that the effective rate was 4%. As the annual premiums were charged to the deposit and applied on the policy, however, the balance in the deposit account decreased and the nominal cash value of the policy increased, causing a gradual increase in the overall interest rate. For present purposes, however, that nuance may be ignored.

loan on which no principal payments had ever been made—was $66,389, and petitioner received a paid-up policy in that amount (Pet. 26-27, 29).

The net result of the transaction was that petitioner was out of pocket $94,616 (the $10,000 initial premium plus $84,616 in "interest" payments) and owned an annuity contract worth $66,389. Had he omitted the purported "payment" and "borrowing" back of the $236,856 and simply paid the same out-of-pocket amounts as premiums, he would have received by the same date a paid-up annuity with a cash value of $98,360 (Pet. 29-30). The reason petitioner chose the actual transaction over that alternative, despite the substantial economic loss it entailed, was his belief that in the actual transaction $84,616 of the out-of-pocket payments, being in the form of "interest" rather than "premiums," would be deductible for tax purposes, producing a tax saving substantially greater than the economic loss (Pet. 27-28, 30).

This proceeding involves only the years 1953 and 1954. In his income tax returns for those years, petitioner deducted the amounts paid the Company ($9,770 in 1953, $19,585 in 1954) as "interest * * * on indebtedness" under §§ 23(b) and 163(a) of the Internal Revenue Codes of 1939 and 1954. The Commissioner disallowed the deductions and the Court of Claims, in a suit for refund duly brought, upheld his determination.

This case is indistinguishable from and is fully controlled by *Knetsch* v. *United States*, 364 U.S. 361. Here, as there, the initial prepayment of the pre-

miums and immediate borrowing back of the amount so paid (here, $236,856) resulted in the creation merely of offsetting paper promises and was wholly lacking in commercial substance. In effect, the Company promised to pay petitioner $236,856 with interest at 2.85% in exchange for petitioner's promise to pay the Company $236,856 with interest at 4%. The purported principal "obligations" could at any time be canceled out against each other (as they were in December 1956), with neither party having any further liabilities with respect to that part of the transaction. For its role in creating the facade, the Company received the 1.15% differential in the "interest" rates. For petitioner, however, the transaction was economically self-defeating; "there was nothing of substance to be realized * * * from this transaction beyond a tax deduction" (*Knetsch, supra*, p. 366). As the Court held of the substantially identical transaction in *Knetsch*, the characterization of a transaction so lacking in commercial substance as creating an "indebtedness" and of the subsequent payments as "interest" is specious and a "sham."

The only difference between this case and *Knetsch* is that Mr. Knetsch not only borrowed back his initial payment of the premiums but also borrowed back each year the increase in the cash value of the contract resulting from his subsequent "interest" payments. Petitioner, in contrast, chose to make the annual "interest" payments out of his own pocket and allow the resulting increases in the cash value of the policy to accumulate for a time, whereupon

he converted them into a paid-up annuity. But the form in which the taxpayer chooses to realize upon the increases in the value of the contract arising from his subsequent payments in no way affects the question whether those payments should be characterized for tax purposes as "interest" or "premiums", which turns instead upon whether the initial transaction—the payment and borrowing back of the amount of the prepaid premiums—is to be treated as giving rise to an "indebtedness." Nor does the fact that petitioner allowed the increases in the cash value to accrue and ultimately converted them into a paid-up annuity give any greater "non-tax substance" (Pet. 5) to the initial payment and borrowing back of the $236,856. Without that step, petitioner would have received a much larger annuity for the same out-of-pocket payments. The only reason for adding the economically disastrous initial step (the creation of the offsetting paper promises at disparate interest rates) was the hope that it would cause the subsequent payments to be characterized as deductible "interest" payments rather than as non-deductible "premium" payments.

There is in any event no conflict of decisions[2] or any other reason for review of the question by this

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[2] The decisions of the courts of appeals are uniform in denying any interest deduction in the type of transaction involved here. See *Carpenter* v. *Commissioner*, 322 F. 2d 733 (C.A. 3), certiorari denied, 375 U.S. 992; *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3), certiorari denied, 364 U.S. 908; *Diggs* v. *Commissioner*, 281 F. 2d 326 (C.A. 2), certiorari denied, 364 U.S. 908; *Pierce* v. *Commissioner*, 311 F.2d 894 (C.A. 9), certiorari denied, 373 U.S. 912; *Salley* v. *Commissioner*, 319

Court: The question is, moreover, of diminishing importance in view of the provisions of the 1954 Code, applicable to contracts entered into after March 1, 1954, expressly disallowing any interest deduction on amounts borrowed, *inter alia*, to prepay the premiums on an annuity contract (§ 264(a) and (b); see also § 264(a)(3) and (c), as added by the Revenue Act of 1964, § 215 (a), 78 Stat. 19). The petition for certiorari should be denied.

Respectfully submitted.

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F. 2d 847 (C.A. 5). The Tax Court decisions cited by petitioner (Pet. 4) were adequately distinguished by the Court of Claims (Pet. 22-23), and the other cases relied upon (Pet. 4) involved not only different kinds of transactions but different questions.

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